



SEMI-ANNUAL REPORT

1 April 2002 – 31 August 2002



USAID/Armenia Tax, Fiscal and Customs Reform Project
10 September 2002

Introduction

Contract number 111-C-00-01-00096-00 was awarded to Barents Group of KPMG Consulting on 6 September 2001 to provide technical assistance for reform in the areas of tax, fiscal and customs. This contract followed-on from an earlier assistance programme which had ended on 30 June 2001.

The goal of the Project is to further tax, fiscal and customs reform by enabling policy makers to formulate and implement informed policy decisions that will further develop the fiscal infrastructure necessary for a market economy and by reforming administrative procedures to improve efficiency, transparency and revenue collections.

Mr Francis Greaney serves as Project Manager and coordinates the work of the long-term resident advisors and the intermittent short-term advisors. Terence Murdoch, the resident Chief of Party, directs the institutional and operational reforms of the Project and also serves as resident Tax Administration Advisor to the Ministry of State Revenues. Brooke Murphy serves as the Project Administrator.

Mr Murdoch is assisted in the work on tax administration reform by John Yates, resident Computerisation Advisor and Jerome Anderson, resident Land and Property Tax Advisor. The Project activities in the area of customs reform are carried out by Alan Morley and David Sloane, Resident Customs Advisors and Vahan Vardanian, resident Computerisation Advisor. Activities in the area of Budgeting were carried out by David Sainsbury, resident Budget Advisor who left the Project in May 2002, and in the Macroeconomic/Revenue Analysis area by Annette Brown, resident Economic Advisor. Edward Koos serves as the Resident Tax Lawyer.

In addition to the work of the resident advisors a number of other professionals have contributed to the technical assistance team. They included Narine Nersesyan (Revenue Analysis and Intergovernmental Fiscal Relations (IGF)), Rita Melhem (IGF), Peter Gusen (IGF), Rodney Mays (IT Network Engineer), Anthony Baiad (IT Quality Control), King Banaian (Economic Advisor), Aneliya Hristova (Revenue Analysis), Peter Griffin (Macro) and William Zuellig (IT Security).

This second semi-annual report gives some detail on the progress to date and any identified obstacles to implementation for each of the main components of the Project. There is also comment on the budget status and any notable schedule changes. An attachment lists those technical memoranda produced by the Project during the period.

Coordination with other Donors and IFIs

Our programme is being implemented in close cooperation with other donor initiatives. Our activities are closely coordinated with both the International Monetary Fund (IMF) and the World Bank (WB) to ensure that technical assistance and training are provided in support of the fulfilment of IFI loan conditions. Our work is also closely coordinated with other US Government Institutions, such as US Treasury and US State Department and with other public and private donor organizations active in Armenia to ensure commonality of objectives and policy approaches and to avoid duplication of effort.

To meet our objective in this area we initiated, and continue to organize, monthly donor coordination meetings in the areas of Budget (US Treasury, IMF, DFID and EU Food Programme) and Customs (EXBS State Department, DFID). In July, DFID discontinued their assistance to the State Customs Committee citing a lack of progress. From the Project's perspective we have not encountered similar problems. In May, DFID commenced direct support to the Ministry of Finance and Economy in the sphere of assisting them in drafting and institutionalising the Medium Term Expenditure Framework (MTEF). We work closely with the World Bank and IMF on loan conditionality issues and continue to provide significant assistance to visiting missions from both organizations.

Principle Activities During the Period

For ease of reference the activities of the Project have been broken down by component and counterpart agency.

Ministry of State Revenue – Tax Administration

Work Plan Activities

A formal work plan for the provision of technical assistance to the Ministry of State Revenues, consistent with the deliverables and timetable noted in the contract, was approved by Deputy Minister Alaverdian, USAID and the Project on 27 November 2001. The work plan covered the following main areas –

- To assist the Ministry to further improve their structural organization and automation
- To assist the Ministry with training to further develop and improve the capacity of all staff to administer the tax laws in a fair, efficient and professional manner
- To assist the Ministry to develop educational materials explaining the tax laws, including record-keeping requirements
- To assist the Ministry to develop manuals governing tax procedures, especially audit and collection procedures
- To assist the Ministry appeals division to improve its procedures and capacity for settling disputes in an efficient and professional manner
- To assist the Ministry to enhance its integrity and efficiency through compensation reform and career path development
- To assist the Ministry in a review of Excise marking, taking into account international practice
- To assist the Ministry in the establishment of a laboratory for enhanced control of automated systems including cash registers.

A major part of our work in the area of tax administration continues to centre around the automated Armenian Tax Information System (ATIS). We continued our ongoing support for the system and, at the same time, pushed the recommendations identified in our comprehensive assessment in the first half of the year in an attempt to rectify recognized problems with the system. Ongoing support has been provided with regard to changes requested by regional offices, updates required because of changes in the legislation and the processing of data to create a central database for the entire Country.

We have provided substantial automation support to the Ministry of State Revenues during this first year of the Project and systems development and implementation has gone mostly according to schedule. Although there have been some delays, most of the key deliverables

were completed on time (see list below). The two primary causes of delay were (1) developing the Goods Production Tracking System significantly ahead of schedule and (2) resolving implementation problems with the WAN. The Ministry requested that the task of developing the Goods Production Tracking System be moved up from a completion date of February 2003 to April 2002. Although the scope of this task had been somewhat reduced, completing this undertaking in such a short timeframe was a significant accomplishment. The result has been that the Excise Stamp Subsystem and the Computer Hardware and Software Inventory Tracking Subsystem were not completed on schedule; however, these systems should still be delivered by the end of the calendar year. Overall, the Ministry, with our assistance, has realized its key goals for the first year of the project and systems development and implementation is on track to complete phase 2 tasks on schedule.

IT Deliverables completed during the first year were:

- 1) Prepared and agreed software development, review, and approval procedures.
- 2) Prepared IT strategy and implementation plan
- 3) Installed the central database on the enterprise server.
- 4) Conducted an assessment of the integrated tax systems developed in cooperation with the Ministry.
- 5) Prepared procedures for processing and distributing customs data integrated into ATIS
- 6) Resolved problems with the ATIS ledger after recommending a committee be created to bring together staff from the IT Department, Methodology Department, regional tax offices, and key department Heads
- 7) Managed the development of the Ministry's website.
- 8) Prepared specifications for a Computer Hardware and Software Inventory Subsystem
- 9) Updated ATIS subsystems based on changes to forms and the law
- 10) Fully updated the users manual
- 11) Finished development and implemented the Property and Land Tax for Legal Persons Subsystems
- 12) Developed and implemented the Goods Production Tracking Subsystem
- 13) Prepared online help for ATIS
- 14) Managed the connection of the 10 Marz Centres to the WAN
- 15) Prepared specifications for the Income Withholding Subsystem for Physical Persons
- 16) Installed a mail server within the MSR headquarters for internal e-mail via the WAN.

To recap, the ATIS (Armenian Tax Information System) assessment conducted in January identified 10 major recommendations for improvement. Eight of the ten were immediately accepted and implementation has been ongoing. Creation of a quality control team, for example, has helped resolve lingering problems with ATIS. Significant progress has also been made in reducing parallel data entry in the old Paradox systems as well as resolution of outstanding problems with the general ledger. Unfortunately, full utilization of the Collections and Audit Subsystems is still not a reality, but having corrected problems with the general ledger it makes these systems more usable. Follow up training, which has already begun, should substantially increase the usage of these two systems. Implementation of the assessment recommendations is an ongoing process and substantial progress has been made

in terms of the full utilization of all systems developed during the current and previous projects.

Little action, however, has yet to be taken on recommendations 6 and 10. Recommendation 6, the creation of a committee to determine standard report formats, has not been undertaken, although key department heads were instructed to update the format of the 1H report—the primary managerial report of the Ministry. As of the date of this report, no final decision on the revised format of the 1H report has been made. Recommendation 10, creation of an IT council to set system development priorities and resolve outstanding systemic problems has been agreed upon, but has yet to be organized. Although minimal progress on these two recommendations has been made, their resolution can, and will, be expedited with the support of the Ministry. We shall continue to work with the Ministry to ensure that these two recommendations are fully implemented by the end of the year.

Training is a key element to successful systems implementation and we delivered the following during the first year of the project:

- Property and Land Tax for Legal Persons
- Updated Financial Subsystem
- Goods Production Tracking Subsystem
- Full ATIS training for new offices including the Large Taxpayer Unit
- On-the-job training for the Collections, Audit, and Legal Subsystems in select offices

Training had been suspended at the start of the year because the Ministry no longer has a permanent training facility. In order to conduct critical training for the new Zeytun RTI and the new Large Taxpayer's Unit, an agreement was reached with the State Customs Committee to use the facility at the Araratian Customs House. Although this arrangement will continue until further notice it does not resolve the problem.

A Tax Service Law was passed in July 2002 by the National Assembly, setting out the rights and obligations of tax officials, including standards of conduct. The Tax Service Law also provides the legal basis for the development of government regulations setting out a disciplinary code for the tax service, including the obligations of the Minister to enforce that disciplinary code. The Law also provides for the creation of a Tax Service Investigation Commission to investigate disciplinary infractions. This is a major focus of interest in our work plan and we will be pursuing, in cooperation with the Ministry, the development of Government decrees, Ministerial Orders and operational procedures to give effect to the monitoring and enforcement of the standards of conduct set out in the Law.

By using the ATIS as the focus of tax administration improvements we must ensure that the system is as effective and efficient as possible. Continual improvement and enhancement of the system is essential to meet this goal. We are currently in the process of conducting an in-depth assessment of the Shengavit RTI to focus on (a) unreported problems in the system, (b) data analysis, (c) data processing procedures and (d) system efficiency. As part of the review we have already provided on-the-job training for the legal subsystem. The Ministry plans to replicate this assessment at the Arabkir RTI.

A security review is also currently underway for all the Ministry's systems. The review will cover system, network and data security as well as physical security. Highlighting deficiencies in security procedures is a critical element of the review.

At the end of August the first generation website for the Ministry was completed and is being hosted at www.taxservice.am. Completion was finalised under great pressure from the Ministry to ensure that it was ready to showcase at the CIS tax conference. The website is available in Armenian, Russian and English.

Obstacles to Implementation

In general, progress with the Ministry of State Revenues continues in a timely manner, particularly when one takes into account the considerable pressure applied upon the tax administration to continually increase revenue collections which understandably deflects their focus from longer-term reform efforts. There are a few points, however, which are worthy of mention which do impede the reform process.

Under utilisation of the collections and audit subsystems – Although we received a variety of reasons for this while we were conducting the ATIS assessment, including some which on later substantiation were found to be groundless, the main reason was clearly a lack of training for current department members. This problem is not only restricted to these subsystems, but clearly they have been hit the hardest due to staff reshuffles and turnover. While we fully appreciate the need for rotation of staff, and indeed would recommend so but less frequently, the Ministry must also bear in mind for the future the problem these ad hoc reshuffles have caused—particularly effecting the Department Heads. It is inefficient to have staff attend training only to be moved to another job without getting the full payback from the training. Recent enhancements to the ledger interface plus a new round of training which is about to commence should go some way to alleviating this obstacle.

Hardware – Availability and Maintenance – In general respondents to the ATIS questionnaire felt that an increase in hardware would provide greater benefit. However, an examination of the current usage indicated that current allocations are correct. We did note that the distribution of hardware within an office varied considerably from office secretaries being allocated a computer to most computers being located within the data entry department. The key point is that no new hardware should be provided to an RTI unless it is fully utilizing all ATIS systems and can demonstrate that the computers allocated are still not enough.

Although few hardware faults were reported, it is important for the Ministry to follow up on these in a timely manner. One common problem that was encountered was the lack of funding to replace or refill printer cartridges. While an interim solution may be found, this can only truly be resolved by allocating sufficient budgets to RTIs for ongoing maintenance of the system.

Training – A key element of any reform programme is training. Implementation of new systems necessarily have a large training component and during the previous USAID contract in excess of 700 staff passed through training programmes developed by the Project. The split of the Ministry in July 2001 also caused the loss of the training centre which had been located within the Araratian Customs House. This has led to two separate but connected problems—(1) The Ministry no longer have any space or facilities to conduct specialised training and (2) the training equipment procured under the last contract remains unused in storage. Accordingly, the Project had to delay some training but we did, however, in the first instance fund outside training facilities to conduct training for those new subsystems which required implementation and then facilitated the use of the Araratian Customs House by the Customs Committee. This is clearly not a satisfactory solution and, indeed, does nothing to force the Ministry to find a permanent resolution.

The Ministry have made formal requests to USAID to provide funding for building refurbishment and perhaps if some funding mechanism is available this could be followed through and will provide the implementation of the training equipment which has been in storage for close to a year.

Conclusion

A satisfactory first year with the Ministry of State Revenues with serious progress having been made on our deliverables within the work plan. Reform of the tax administration will never be an easy process due to the continual revenue pressure applied to the MSR but we have been able to demonstrate the real benefits of procedural, including automation, reform and I believe that Ministry personnel have recognised this and supported us accordingly.

State Customs Committee – Customs Administration

Work Plan Activities

A formal work plan for the provision of technical assistance to the State Customs Committee (SCC), consistent with the deliverables and timetable noted in the contract, was approved by Armen Avetissian, Chairman of the SCC, USAID and the Project on 5 November 2001. The work plan covered the following main areas –

- Assisting the SCC to reorganize and modernize Customs administration
- Establishment of a Customs Advisory Committee
- Assisting the SCC to develop the capacity to administer the Customs Code in a fair, efficient and professional manner
- Assist the SCC Appeals Unit to improve procedures
- Assisting the SCC to ensure compatibility of Customs legislation with WTO requirements
- Assisting the SCC to ensure compatibility of tax and customs IT systems
- Assisting the SCC to develop and introduce a Code of Ethics

An IT gap analysis and an IT hardware and software strategy plan for Customs was completed by the Project and agreed upon with the SCC as the basis for the IT equipment procurements we are currently undertaking. We conducted considerable meetings with Customs IT staff and users to identify necessary inputs for the documents and identified the existing information flows and reporting processes as well as the declaration processing volumes at all Custom Points and Customs Houses. This information was used to fine-tune the procurement requirements. By the end of July we finalised evaluation of the proposals received for the main hardware procurement and selected the winning vendor. The purchase order will be issued immediately upon receipt of approval to subcontract and a waiver for the passport readers and some printers which do not satisfy the source/origin requirements.

We set up an ASYCUDA emulation environment within our office to be used for staging and testing recommended solutions. We tested installation procedures for v1.16 and migration sequencing from v1.13 to v1.16 as well as migrating Armenian language settings to avoid re-translating of the forms and labels from v1.13. The testing and preparation of functional and instructional manuals for use with the upgraded ASYCUDA system has continued. Declarations, assessment notices and accounting receipts can now be printed out.

In preparation for upgrading the automation environment of the SCC we assisted in the installation of a Local Area Network within the Customs Headquarters as well as assisting in the electrical upgrade and computer networking within the training centre at Araratian Customs House. As well, we installed a high-speed data communication link between the Customs Headquarters and the Araratian CH. We also configured the reporting system that is currently in use at Araratian CH to be used at Customs Headquarters. This reporting system is a key component to ensure the smooth transition to the upgraded version of ASYCUDA.

We also investigated potential options for the development of a Customs Web site, including design concepts, technology tools selection and hosting options. The SCC Chairman's approval was secured and a coordinator from the SCC was appointed. In March, however, the Prime Minister's office issued instructions to all Ministries regarding the development of government web sites and we encountered some delay awaiting clarification from the Customs Committee. The Customs Committee subsequently reconfirmed its commitment to the development of a web site and following the completion of preparatory work by the Customs Committee and our project staff, an experienced Armenian web site developer was contracted to complete the design of the Customs web site. The site is anticipated to be fully operational in mid-October 2002.

A project proposal has been prepared for the conduct of a pilot study of full Customs clearance at the rail border point at Ayrum. Given the findings of the Reconfirmation Workshop that such a pilot study should not be undertaken before installation of a computer network, we formally amended the work plan to adjust the timeframe for this activity to January-April 2003.

We developed and installed a training tracking software program at the Customs Training Centre. This program will enable the Training Centre to catalogue the training history and training needs of every employee of the Customs Committee.

The reconfirmation report recommended the creation of a Customs Procedures Simplification Task Force within the Customs Committee, having an ongoing mandate to review, improve and simplify Customs operational procedures during the course of the reform process. We prepared a document setting out a methodology for evaluating procedures and prioritising the extent to which modifications are required to effect improvements and presented it to the first meeting of the Customs Procedures Simplification Task Force, which was held in March 2002. After reviewing the material, Mr. Afrikyan (in his capacity as Chairman of the Task Force) concluded that it was premature to embark upon a systematic review of procedures in advance of the implementation of the upgraded ASYCUDA system and the Customs WAN. We will pursue this issue further with Mr. Afrikyan in the coming months.

Agreement was reached with the Customs State Committee on the participant list for a study tour to be conducted to Latvia in mid-September. A major focus of the study tour is to provide to the Armenian Customs officials the opportunity to study the Latvian Customs ASYCUDA system, which has already been successfully upgraded to the current version of ASYCUDA. Accommodation, travel arrangements and other logistical requirements in support of the study tour have been completed.

A number of passport readers, together with specialized software we have developed, were installed at the Bagratashen Market Customs Point at the end of August. The purpose of these passport readers is to provide to Customs the operational capability to verify the use of

travellers' import exemptions, which by law can be used only once per calendar month. When the reader reads a passport, the software stores the information in a cumulative database and identifies to the officer whether the holder of the passport has or has not used the exemption previously within the current month. Technically the systems works well. However, in view of the very large numbers of people using the market, process streamlining will be required to make this system operate effectively. We are assisting the Committee to develop simplified and streamlined operational procedures specifically for the unique situation at Bagratashen in order to facilitate, but still maintain control of, the trade at the market crossing point.

Evaluation of the proposals for the Customs WAN was completed in July and we started negotiations with the selected vendor. Due to the relatively poor quality of proposals we decided to conduct 'proof of concept' tests at selected customs points. Such a test at Bagratashen concluded that using dedicated telephones lines to connect that border point was not a viable solution due to both unsatisfactory data transfer speed and instability. Although a second test at Meghri border point was slightly better in terms of transfer speed, the stability of the dedicated line was too poor to accept as a workable option. We have investigated the possibility of alternative connection options such as radio modem and HF radio but have also found these to be impracticable. We have, therefore, concluded that the WAN should be split into two phases: (1) land-based connections, and (2) satellite connections. InfoService, the vendor with the highest proposal evaluation from the tender process, is ready and qualified to implement phase one, the land-based solution. Phase two will require a further tender process to identify a suitably qualified vendor. Dividing the work into two phases should provide a solid solution at a reasonable cost.

A Customs Service Law was passed in July 2002 by the National Assembly, setting out the rights and obligations of Customs Officers including standards of conduct. The Customs Service Law also provides the legal basis for the development of government regulations setting out a disciplinary code for the Customs service, including the obligations of the Head of the Customs service to enforce that disciplinary code. The Law also provides for the creation of a Customs Service Investigation Commission to investigate disciplinary infractions. This is a major focus of interest in our work plan, and we will be pursuing, in cooperation with the Customs Committee, the development of Government decrees, Chairman's Orders and operational procedures to give effect to the monitoring and enforcement of the standards of conduct set out in the Law.

The DFID technical advisor to Customs, who had been awarded a role within our agreed work plan left the Country at the end of July and will not be replaced. Accordingly, during August we conducted a series of meetings with officials from the SCC to re-establish the role of the Project in those activities that had been the purview of the DFID advisor. The specific areas of consideration were the establishment of a selective examination programme, the benchmarking of key Customs activities and the improvement of Customs control measures at Zvartnots airport. It was agreed that the Project will take on these tasks, on which very little progress had been made.

Obstacles to Implementation

Overall, progress to date has been highly satisfactory. There are a few points worthy of mention though:

ASYCUDA – The ASYCUDA system was developed and distributed by UNCTAD. One of their aims is to seek opportunities for the provision of technical assistance in this area and identify work that can be done by them on a fee basis. Their position is that they only work directly with governments and view our Project only as a funding provider, meaning we cannot receive any direct technical support from them. Although not a major barrier, it may cause some problems as we move to upgrading the SCC to the new version of ASYCUDA. We encountered considerable delays from UNCTAD over a period of seven months in our attempts to assist the Customs Committee to obtain an official version of the upgraded software. After an extensive exchange of correspondence, several meetings with UNCTAD representatives, and the negotiation of an amended Memorandum of Agreement between the Customs Committee and UNCTAD, we understand that an official copy of the ASYCUDA version 1.16f software was sent by UNCTAD to the Customs Committee at the end of August 2002. We are awaiting receipt of the package by the Customs Committee, following which we can begin immediately the process of assisting the Customs IT department in migrating to the upgraded version.

Procurement Issues – Part of our contract deliverables is to upgrade the IT hardware requirements for the SCC, which will involve high value procurements. We are conscious of the problems we have encountered in past procurements to Armenia with respect to the long delivery time and the necessity to meet US source and origin rules. To ensure that implementation of the activity is not unnecessarily delayed we opted for a small part-procurement for the pilot site at Bagratashen to both test the ASYCUDA system upgrade as well as the test of the new border control system using passport readers. The passport readers have been received and successfully installed at Bagratashen and we are now awaiting approval by USAID of a country clearance waiver request for the particular printers required for use with the ASYCUDA system in Armenian fonts, so as to be able to proceed with the major procurement.

Wide Area Network – Bids in response to an RFP we issued for the design and installation of a Customs Wide Area Network were evaluated in July 2002 and a successful bidder was identified (the other vendors who submitted bids did not propose viable solutions). However, subsequent field tests of technical options other than satellites to connect the Customs border sites have not been satisfactory and we are contemplating the preparation of a supplementary RFP for satellite connections to selected border offices.

The Chairman's Consultative Committee - Efforts to expand the Chairman's Consultative Committee to include representation from a broader range of the private sector and include representation from other agencies and Ministries involved in the import and export processes (as recommended by the reconfirmation workshop) have so far met with resistance from the Chairman of the Customs Committee. This is an initiative that had been undertaken by the DFID Customs Advisor pursuant to a Memorandum of Agreement signed by USAID, the British Embassy, Barents Group and the Customs Committee in December 2001. With the conclusion of the DFID Customs advisory project in July 2002, we have now re-assumed this activity and will be pursuing it actively with the Customs Committee in the coming months.

Conclusion

Our mobilisation in September 2001 was accompanied by considerable concern being raised by other international donors providing assistance to Customs over a perceived lack of cooperation and interest for reform by the SCC. Despite meeting for the first time a new organisation with a new senior management we were able to quickly establish a very good

working relationship and, through this, were able to bring other donors (DFID and US Customs) on board with us. As time has passed our cooperation has continued to strengthen and it is pleasing to note that all activities agreed within the work plan are progressing well.

We anticipate considerable activity over the next six months with receipt of the hardware procurement and subsequent installation of the upgraded ASYCUDA program.

Ministry of Finance and Economy – Budget

Work Plan Activities

A formal work plan for the provision of technical assistance to the Ministry of Finance and Economy (MFE), consistent with the deliverables and timetable noted in the contract, was approved by Pavel Safarian, First Deputy Minister, USAID and the Project on 18 December 2001. The work plan covered the following main areas –

1. Assisting the MFE to improve their capacity to prepare an annual Medium Term Expenditure Framework (MTEF)
2. Assisting the MFE to formulate and execute realistic budgets
3. Assisting the MFE in the improvement of their Budget Database
4. To provide recommendations on the improvement and use of Budget instructions
5. To develop recommendations to increase budget transparency
6. To develop recommendations to improve the Budget Law and related legislation
7. To provide recommendations on improvements in the operation between the Budget and separate legal entities
8. To encourage Programme Orientation in budgeting

Our activity in the budget sphere continued where we left off in March with protracted discussions with the Ministry of Finance and Economy (MFE) on the relative roles of the Project, other donors and MFE officials and the Government of Armenia in preparation of the 2003-2005 Medium Term Expenditure Framework (MTEF). Discussions with the First Deputy Minister indicated an unwillingness/inability on the part of the MFE to devote significant resources to the preparation of the MTEF. This was said to be due at least in part to the imminent commencement of the Budget process in June. Nevertheless, the MFE did accept the value of continuing MTEF development and expressed a willingness to set up committee structures to be involved in the preparation of the document. This system of committee structures and working groups was consistent with that proposed in our recommendations to the MFE in February 2002.

The outcome of the negotiations with the MFE was that USAID agreed that the Project would fund and supervise local consultants to prepare a 'limited scope' MTEF for 2003-2005 by the end of August for presentation to the Ministry. This was on the understanding that the MTEF process for 2004-2006 will be largely undertaken by MFE with increased policy input by the Government and specific donor assistance from DFID. The aim being to make the MTEF a more effective tool in the Budget preparation process.

In conjunction with the timing of the above negotiations DFID commenced a relatively large assistance programme directly related to providing the MFE with assistance in the development and institutionalisation of the MTEF process. Further, our resident Budget Advisor, David Sainsbury left the Project and in view of the new assistance being provided

by DFID, USAID made the decision to suspend further assistance in the budget area pending a review of needs once DFID had completed a period of transition.

We awarded the sub-contract for preparation of the 'limited scope' MTEF to AVAG Solutions Limited, a local Armenia consulting firm whose prime personnel consisted of Messrs Avenissyan, Barkhudaryan and Yeghiazaryan, all former Ministers of Finance or Economy, who have considerable experience in the budget field. The first draft was submitted to Pavel Safarian, First Deputy Minister of Finance and Economy, on 21 August and work is ongoing reviewing the draft through the Ministerial Coordination Committee. The draft consisted of the following chapters as agreed:

- Macroeconomic Policy and Forecast
- Tax Policy and Forecast
- Budgetary Framework
- Education
- Health Care
- Social Security and Social Insurance
- Water System
- Public Investment Projects

We carried out an assessment of the current budget preparation database being used by the MFE and in June we presented our proposal for the development of an improved operational budget system database. We await the Ministry's evaluation of our proposal.

Obstacles to Implementation

The Budget side of the Ministry of Finance continues to be notoriously difficult to engage in meaningful reform activities. Reform activity is at the whim of Pavel Safarian, First Deputy Minister, whose autocratic rule over his Department inhibits even lower level engagement. Despite the presence of considerable donor assistance in the form of technical assistance over the years there has been little progress in reform of the budget process. Safarian views technical assistance as a means to produce output for the Ministry in areas where he feels he does not have sufficient resource. Although this can lead to the production of improved technical output it also makes it very difficult to introduce institutional reforms within his Department.

The departure of our resident budget advisor permitted USAID to suspend current activity in this area pending an evaluation of the role and progress of DFID in the institutionalisation of the MTEF process.

Conclusion

In terms of deliverables we have provided the MFE with detailed guidance on institutionalising the working structures for the MTEF process as per item 1 of our workplan and it was pleasing to note that these structures were established by Government Decree and are being used in the current MTEF process. We have, of course, also provided them with significant assistance in completing the draft for this year through our sub-contract with AVAG Solutions. It is difficult to envisage any further need for assistance in the MTEF area in the future, however, with the arrival of DFID.

We also delivered item 7 in our workplan and again it is of some comfort that following our advice and recommendations, the MFE are reassessing their proposed approach in the area of

subsidies to public non-commercial organisations and their future relationships with the GA and the Budget.

The only area of ongoing assistance at this time remains the improvement of the budget preparation database. We have provided the MFE with detailed proposals but still await the result of their considerations. We have deliberately not pushed for a response as we do not view this area of being high priority in the overall IT side of the Project.

Ministry of Finance and Economy – Macroeconomics

Work Plan Activities

A formal work plan for the provision of technical assistance to the Ministry of Finance and Economy (MFE), consistent with the deliverables and timetable noted in the contract, was approved by Tigran Khachatryan, Deputy Minister, USAID and the Project on 19 November 2001. The work plan covered the following main areas –

- To assist the MFE to perform economic analysis through policy advice and joint studies
- To evaluate the current set of macroeconomic models used inside and outside of Government and advise on improvements and optimal uses for these models
- To publish economic reports and facilitate improved economic analysis

We have continued to draft and publish the Monthly Economic Update and the Budget Bulletin for distribution to the Government, other donor agencies and IFIs.

Our first task under the macroeconomic umbrella was in response to a specific request from Deputy Minister Tigran Khachatryan that our Economic Advisor concentrate her efforts on assisting with the Poverty Reduction Strategy Paper (PRSP) process. The PRSP process is governed by the Steering Committee, comprised of high-level government officials, and the Working Group, which is chaired by Deputy Minister Khachatryan, and comprises government officials, NGO representatives, and donor agency representatives. Dr. Armenak Darbinyan, the Director of the Economic Research Institute, is a member of the Working Group and the Coordinator of all work of the Expert Groups. These groups delivered analysis and recommendations to the Working Group and Steering Committee to be incorporated into the draft PRSP. One of our staff economists accepted a position on the Expert Group for Economic Policy and the Resident Economic Advisor participated in the meetings of several Expert Groups.

Our REA, at the request of the MFE, spent considerable time over the period in this task and gave detailed advice, recommendations, and comments on the development of the process. Her participation included attendance at several series of meetings as well as at the large seminar in Tsakhkadzor to review the first draft of the document and a seminar presented by the World Bank on costing. She wrote a series of technical memoranda, which were submitted to Mr. Khachatryan and Dr. Darbinyan as well as to USAID. Some of these memos were distributed widely among the PRSP experts. She worked directly with several of the experts to provide technical assistance regarding both their economic analysis and their policy recommendations. She also occasionally served as a liaison between USAID and the PRSP process and gave a presentation on the PRSP process to the Mission and to a regional USAID conference. She coordinated with several other donors and advisors in Armenia

regarding the PRSP process (e.g. DFID, GTZ, USAID Legislative Strengthening.) During the period, our local economist contributed significantly to the macroeconomic framework portion of the PRSP focusing on analysis of growth as it relates to inequality and poverty.

Although the latest draft of the PRSP has not been translated into English as of the writing of this report, we can summarize some of the concerns about the PRSP that have arisen from the earlier drafts and the recent meetings. First, the strategy is not organized around a clear set of over-riding goals or objectives. The targets identified are mostly target demographic groups rather than target economic objectives. Without unifying objectives motivating the strategy as a whole, it is not only difficult to bring the specific recommendations of the strategy into the context of poverty reduction, it is also difficult to place the PRSP itself within the context of Government plans and programs (and donor plans and programs) more generally. As noted, the lack of unifying objectives partly explains the second shortcoming, which is that the linkages between the various topics of coverage and among recommendations are weak or missing. These linkages are often missing both on the policy recommendation side (e.g. one expert recommends increasing emphasis on a certain policy or program while another recommends reducing it) and on the analytical side (e.g. one expert bases recommendations on a forecasted increase in tax revenues as a per cent of GDP and another on a forecast of steady tax revenues as a per cent of GDP.) And this points to the third shortcoming, which is that the document generally is lacking in analytical rigor and the economic analysis, both quantitative and qualitative, is often quite weak.

We also identified some problems in the PRSP process that will help to explain the shortcomings in the document. Addressing these procedural issues in the future should help reduce shortcomings in the future.

The first procedural problem was the Terms of Reference (TOR) itself. The concept of having a TOR for the PRSP was a good one. It was an attempt to organize a very complicated process, and the attempt should be commended. The TOR itself, however, was too ambitious and too departmentalised. Not only did it not allow for research and analysis to determine the focus of the PRSP, it did not allow for a focus. That is, it included almost every aspect of economic and social reform imaginable and it assigned each different aspect to a different expert. While the TOR attempted to organize the work and make sure that all the bases were covered, it ended up keeping all the bases separate and discouraging the kinds of linkages that are so important.

The second problem with the process was the choice of experts. While the Government should be commended for including a broad array of experts, there were some problems with the choice of experts. In some cases, the experts simply did not have the ability or training necessary for the level of analysis needed in the PRSP. Also, the experts did not include enough representatives from the Government, so that the document seems more like a proposal presented by civil society to the Government, rather than a strategy developed by civil society and Government working together. Not only is Government involvement essential to guarantee Government commitment to the strategy, it is important for getting the necessary information to the analysts for drawing their conclusions and making their estimates. Experts were also not always assigned roles in the process to take the best advantage of their strengths. The prime example was the appointment of a parliament member as the head of one of the expert groups. While it was great to have a parliament member involved in the process, the competing demands on his time and his emphasis on

political aspects rather than technical details made it difficult for him to play the coordinating and consolidating role necessary for that position.

The third problem with process, closely related to the first two, was that there were no differences or changes or developments in the process over time. As a first example, the TOR laid out the importance of three aspects of the PRSP: measuring and understanding poverty, developing policy recommendations, and measuring and monitoring progress. It correctly identified those as the necessary components, but it did not recognize the necessary sequencing. All three were carried out simultaneously, where analytically they should be carried out sequentially. The causes of poverty should motivate the proposed policies, and the proposed policies should determine what kind of monitoring and measurement is feasible.

These criticisms are not to suggest that the process has not been worthwhile or that the input of the chosen experts was not constructive. A lot has been learned, and awareness has increased. It seems likely at the moment, however (and again the most recent draft is not yet available in English) that the first PRSP will not be as useful a document as the Government and the donors may have hoped.

In April we re-established the Economics Roundtable Series. At the first meeting of the new series, a panel of presenters discussed the topic “The Economic Situation in Armenia at the Beginning of 2002 and Key Issues for Further Development.” Panel members came from the Ministry of Finance and Economy, the Central Bank, and the World Bank, and we prepared and distributed a written summary of the meeting. The second meeting of the new series was presented by Ms. Gohar Minasyan of the IMF who presented her paper on “Factors Influencing the Share of Tax Revenue in GDP.” After the meeting, a summary of the paper was distributed to the attendees and all others on the roundtable invitation list. It should be noted that the Economics Roundtable Series has been temporarily put on hold at the request of the Ministry. We held several discussions with both Mr. Khachatryan and Mr. Muradyan about the concrete outputs from the Series. In the absence of an agreement on the general purpose of the Series and with the arrival of our short-term advisor Dr. Banaian who would be chairing a series of Working Group meetings on reviewing macroeconomic models, it was decided to table the Series in the meantime.

In the middle of June, Dr. King Banaian arrived for a two month visit to work on two tasks. The first was to develop a model and write a paper analysing the relationship between inflation and growth. The second task was to chair a Working Group on Macroeconomic Forecasting Models and to write a final report of the Working Group’s activities. The Working Group was appointed by the MFE with the assistance of the REA. The Group is comprised of two representatives from the MFE, one from the Central Bank, one from the IMF, one from AVAG Solutions, one from EDRC, the RMA, Barents staff, and the Chair.

Dr. Banaian’s report on money demand, titled “Inflation, Growth, and Money Demand,” was completed in August and was submitted to the Ministry of Finance and Economy and also given to USAID. This study was designed to address the concerns of the Ministry of Finance and Economy that too much emphasis of economic policy in Armenia has been on price stability with a consequent negative impact on economic growth. The study explores a variety of models to address the questions raised by this concern. The models include a combination of single-equation regression analysis, parts of a structural econometric model, a vector error-correction model, and a panel-data study of other transition economies.

The various models yield the following conclusions:

- Movements in the velocity of money (the rate at which money turns over in the economy) help explain movements in inflation. The relationship is strongest between dram M2 money supply and inflation measured by the GDP deflator. Weaker, but still useful, relationships exist between broad money (including foreign currency-denominated deposits) and inflation. A permanent rise in dram M2 velocity from 1.4 to 1.5, representing a drop in the demand for money, leads to about a $\frac{3}{4}\%$ point rise in the monthly inflation rate.
- There is a stable, long-run money demand relationship in Armenia. This is a prerequisite for inflation targeting, which seems to be a mechanism of monetary policy implied in the government's letter of intent with the IMF. Moreover, the tradeoffs between output growth and inflation are not too costly in Armenia. The results of the study suggest that a 1 percentage point reduction in inflation costs the Armenian economy approximately 0.6 percentage point lower GDP growth, via the usual Phillips curve relationships.
- The models developed can be used for short-run forecasts of the economy. Based on an extract of the larger Barents model, output growth for 2002 would be expected to reach 7.5% and inflation 3.9% (using the GDP deflator.) From the vector error-correction model using monthly data the forecasts were 6.5% and 5.3%. These differences are statistically insignificant.
- Within a panel-data study of six transition economies, it appears that sustained inflation rates below 10% do not cause harm to long-run economic growth. Growth depends more on factors such as increasing trade openness and investment shares of GDP. Above 10%, the long-run rate of growth of the economy is reduced 0.13 percentage points for each additional 1 percentage point of inflation.

Dr. Banaian also presented a seminar based on the report at the Ministry of Finance and Economy. We have already had some discussion with USAID about possibly writing a policy brief or less academic version of this report and hope to follow up during September.

In connection with his work as chair of the Working Group on Macroeconomic Models, Dr. Banaian developed working models of each of the forecasting models presented in the group. This included reacquainting other members of the group with the Barents model. The model is currently the only one specifically designated to forecast broad macroeconomic aggregates such as real GDP or inflation. Other models are largely consistency checking mechanisms that take goals for real GDP and inflation and then divide out by some past averages the amount of GDP that will be due to consumption, to investment, or to the trade balance. Significant discussions were held on how the model might be improved, taking advantage of seasonally adjusted data and findings of the Central Bank of Armenia (CBA) staff that there may be long run relationships towards which some economic phenomena will trend through a process called "error correction". A preliminary report of the working group is expected in mid-September, as one of two deliverables in Banaian's scope of work.

During the period we developed together with the MFE a Request for Proposals titled "Publication of 'State Economic Policy and Poverty,'"". The objective of the project is to better inform both those who work in the Government and those outside of it about both the Government's initiatives in the area of economic reform and the motivations, analyses, and forecasts that underpin those initiatives. Such understanding among civil servants and civil society is increasingly important as the Government of the Republic of Armenia undertakes

economic reforms and implements new economic policy in support of its market economy and to achieve the goal of reducing poverty. We shall seek an NGO to compile, write, edit, and publish the journal titled “State Economic Policy and Poverty” presenting such information to be distributed to interested parties in civil service and civil society. The journal will be published in both Armenian and English and will be governed by an Editorial Board, selected and approved by the Ministry of Finance and Economy of the Government of Armenia (MFE) and composed of representatives from various Agencies and Ministries within the Government as well as representatives from outside the Government. The REA will serve as the Executive Editor. The RFP has been published and we are currently working with the MFE and USAID to form the evaluation committee.

Obstacles to Implementation

Both the MFE and the Economic Research Institute (a wholly State-owned CJSC) have expressed considerable interest in the Project’s provision of technical assistance in the macroeconomic area. This is an area where it is very difficult to identify specific and/or measurable indicators of performance. The Ministry take the view that only by working closely with international advisors will the overall quality of their own staff be raised.

Conclusion

Progress has been highly satisfactory with counterparts who are very interested in the receipt of technical assistance. Our involvement in the PRSP process has involved considerably more resource than initially anticipated but it is clear that it has been particularly welcomed by Deputy Minister Khachatryan.

Ministry of Finance and Economy – Tax Policy

Work Plan Activities

A formal work plan for the provision of technical assistance to the Ministry of Finance and Economy (MFE), consistent with the deliverables and timetable noted in the contract, was approved by Tigran Khachatryan, Deputy Minister, USAID and the Project on 19 November 2001. The work plan covered the following main areas –

- To complete an analysis of current tax legislation
- To complete an analysis of state and local duties and fees
- To assist the MFE develop the capacity to formulate sound tax policy
- To conduct a review of principles and content of double taxation treaties

The Project is leading, at the request of the MFE, a comprehensive review of tax policy in Armenia. In June the MFE and MSR, with input from Barents, agreed on the review procedure and committees were formed by each of the participant bodies. The ministry committees are comprised of staff within each ministry, while the committee headed by the Project is comprised of Barents staff and representatives from the AAAA (Armenian Association of Accountants and Auditors) and UMB (Union of Manufacturers and Businessmen). Each committee has general responsibility for the following areas:

- MFE—tax policy
- MSR—tax administration
- Barents—impact on business.

Seven separate workgroups covering the following areas have also been established:

- ❖ Profit Tax
- ❖ Income and Social Tax
- ❖ Value Added Tax and Excise
- ❖ Land and Property Tax
- ❖ Presumptive Payments and Simplified Tax
- ❖ Law on Taxes
- ❖ State and Local Duties, Environmental Tax.

Each workgroup is comprised of representatives from the MFE, MSR and Barents, along with representatives from the Association of Accountants and Auditors of Armenia (AAAA), the Union of Manufacturers and Businessmen (UMB) and the Community Finance Officer's Association (CFOA). The workgroups commenced their meetings in June and the expected output from this work shall be a series of reports from each of the working groups on their review of each of the areas as noted above. Each review will cover three main areas – legislative, administrative and quantitative – and include an identification of the main areas for change with rationale for the recommended change. The issues raised during the workgroup meetings will then be analysed by the three committees (MFE, MSR and Barents) to determine if there are any conflicts with other taxes or with the committee's overall objectives. At the conclusion of this review each of the workgroups will produce a report that addresses issues of policy, administration and business impact. The reports will conclude with short and long-term policy and administration recommendations.

The workgroups have been meeting on a weekly basis since formation and attendance and participation by all members has been most encouraging. In July we drafted and distributed the background sections of each of the reports and we are now in the process of drafting and translating Part II (policy and general recommendation) of each of the workgroup reports. The translated reports will be distributed to workgroup members for comment.

Under item 3 of our work plan, and at the request of the MFE, we completed an initial report on Tax Expenditures. We reviewed and modified the proposed reference baseline and deviations from that baseline that represented tax expenditures. Our output was a report on the identification of tax expenditures which was presented to Deputy Minister Tigran Khachatryan. Discussions on the report with the MFE initiated a request to commence quantification of the expenditures but as we had also reviewed data availability as part of our assignment (which we found to be sadly lacking both in terms of quantity and quality), we appraised the Deputy Minister of our findings and it was agreed to postpone any quantification until a full data needs assessment had been completed. The Revenue Analysis component of this report gives further details of action in this area.

Obstacles to Implementation

In our previous report we highlighted the difficulties between the MSR and MFE over the fact that although the responsibility for tax policy and tax legislation lies directly with the latter Ministry, the MSR believe they should hold that role and often work at cross purposes. This disagreement in roles and responsibilities between the two Ministries also delayed the start date of the comprehensive tax policy review. It was with some pleasure that the Project was able to bring the parties together and reach consensus on their respective roles in the review.

Conclusion

Work is progressing very steadily in this activity and to date we are pleasantly surprised just how well the working groups in the review have progressed. The structure of the groups has also facilitated direct discussion on tax policy issues of interest to both the MFE and the MSR where it has been clear that little communication on the issues had been raised in the past. If future progress continues as it has to date we would anticipate a most positive outcome of the review.

Ministry of Finance and Economy – Revenue Analysis

Work Plan Activities

Formal work plans for the provision of technical assistance to the Ministry of Finance and Economy (MFE), consistent with the deliverables and timetable noted in the contract, were approved by Tigran Khachatryan, Deputy Minister and Pavel Safarian, First Deputy Minister, USAID and the Project on 19 November and 7 December 2001 respectively. The work plan covered the following main areas –

1. To complete an analysis of revenue performance in 2001
2. To complete revenue forecasts for 2002-2005
3. To develop direct and indirect tax simulation models

Items 1 and 2 of the workplan were completed on time and delivered within the first six months of Project activity. Item 3 was planned to commence in the latter half of 2002 and continue through the end of 2003 but at this time we have postponed inauguration of this activity due to the perceived unreliability of the current data. To assist in overcoming this problem we have commenced a Data Needs Assessment and are cataloguing the tax administration data for the purpose of revenue and tax policy analysis. The objective for this work is to convert the existing tax administration data into a format more easily accessible for analysts; catalogue the variables available for each tax's database; assess data quality, identify problems and document findings; and to develop recommendations for further improvements in the tax administration data.

Obstacles to Implementation

Institutional reform in this area is difficult for two main reasons: (1) lack of availability of quality data and (2) the fact that the analysis is split between three separate entities (MFE Budget, MFE Macro and MSR) who seem to apply little coordination. The first obstacle can, and indeed will, be overcome as the volume of quality historical data becomes available through the ATIS. We shall continue to press the MSR to make this data available to their colleagues in the MFE. We hope the latter will improve through our assistance by way of joint workshops and seminars.

Conclusion

Good progress being made in this area with all counterparts willing to engage in meaningful discussion.

Ministry of Finance and Economy / Ministry of Territorial Administrations – Intergovernmental

Work Plan Activities

Formal work plans for the provision of technical assistance to the Ministry of Territorial Administrations (MTA) and the Ministry of Finance and Economy (MFE), consistent with the deliverables and timetable noted in the contract, were approved by Vache Terteryan, Deputy Minister (MTA) and Pavel Safarian, First Deputy Minister (MFE), USAID and the Project on 20 November and 7 December 2001 respectively. The work plan covered the following main areas –

- To conduct a comprehensive review and analysis of intergovernmental fiscal relations
- To develop a comprehensive intergovernmental fiscal information system
- To carry out a study on the existing system of intergovernmental transfers

The Intergovernmental Fiscal Review was completed by the middle of June and included meetings with the Ministry of Territorial Affairs, Ministry of Finance and Economy, World Bank, Urban Institute, GTZ, Community Finance Officers Association, communities of Artashat, Giumry and Dilijan, as well as Artashat-Marz governor and finance officers. We analysed expenditures and revenues of local government units, evaluated responsibility assigned to local governments, the distribution of expenditures across functions and according to economic classification and how the cost of providing services varies from community to community.

The first draft of the report was delivered to MTA and MFE and the main chapter headings were as follows:

- Local Government Framework
- Expenditure Assignments
- Revenue Assignments
- Intergovernmental Transfers

Each chapter was further split to cover (1) Conceptual foundations (2) Armenian Situation (3) Comparison with Other Countries and (4) Issues/Findings. Formal presentations on the report were delivered to Messrs Safarian and Terterian, as well as USAID.

Subsequent meetings were held with both parties once they had a chance to digest the content of the report. On the whole they were very pleased with the content and very complimentary on the deliverable. Many of the comments related to updating the report by reference to the new Law on Local Self-Government which had been passed in parallel with our completion of the final draft report. They will now decide priorities on where further technical assistance by the Project is required in order to best facilitate fiscal decentralisation.

Discussions with the MFE and MTA were concluded on the development of a comprehensive intergovernmental fiscal information system. This would include the collection of data and creation of a comprehensive database to include economic, demographic and fiscal information for all 930 communities within the Republic. The database will support the ongoing work in the intergovernmental area and become a working tool for analysis of various policy issues under consideration for all primary users. We awarded the sub-contract for collection of this data to the Community Finance Officer's Association (CFOA) at the end

of July and we anticipate completion of the work by the end of the first quarter of 2003. The Project will oversee the CFOA collection efforts and work closely with them in developing the software for the database.

Obstacles to Implementation

Although we have not fielded a resident advisor in this component as was proposed in our original proposal we have been able to more than satisfactorily cover this area through the use of high quality short-term advisors. We have not encountered any obstacles in our work to date but clearly this area is full of uncertainties, even with the enactment of the new law on Local Self-Government in June.

Conclusion

Work is progressing as agreed within our work plan.

Ministry of State Revenue / Ministry of Finance and Economy / Ministry of Territorial Administrations / State Cadastre Committee – Land and Property Tax

Work Plan Activities

One important activity with respect to property and land tax reform in the reporting period was the two-day seminar held in Tsakhkadzor to identify issues and develop alternative solutions for the property and land taxes. Twenty-six representatives from nine different organizations took part. Discussions were held on decentralization, valuation, computerization, draft legislation and other topics. This was in all likelihood the first meeting of its kind in Armenia. All participants contributed to the discussion and many suggested that a follow-up seminar be held.

A second important action during the reporting period was the commencement of the tax policy work group meetings. These meetings are important because, for the first time, representatives from the Ministry of Finance and Economy (MFE) became fully involved in land and property tax issues. In addition, the representative from the Ministry of State Revenue (MSR) participates regularly in these meetings and offers valuable input. Creation of this formal mechanism for discussion of land and property tax issues has made our counterparts from these ministries active and committed participants in the process of property and land tax reform.

A third important action during the reporting period was the passage of the revised Law on Local Self-Government. The law was passed on 7 May 2002 and came into effect on 21 June 2002. The law contains a provision requiring communities to collect property and land taxes and presumably gives communities more responsibility for tax administration. While the details of these powers must be more clearly defined in subsequent legislation or regulations, passage of this law is an important step in decentralization of fiscal authority to the communities of Armenia.

While this legislation is extremely important and necessary, one of the main items of discussion at the Taskhkadzor seminar was the ambiguity caused by language in this law. The participants in the seminar who represented the interests of the communities noted that while the newly-passed Law on Local Self-Government gives communities the authority to “collect (levy)” property and land taxes, as well as “supervision” over property and land taxes, there are significant questions left unanswered, not the least of which is the division of

responsibility between the Ministry of State Revenue and the communities. One specific issue is the preparation of tax bills. One could argue that preparation of the tax bills should fall within the purview of the communities' authority under the Law on Local Self-Government. This is an especially important issue because citizens often have questions concerning their property tax bills. If the community delivers those bills, but has not prepared them, the community representatives cannot answer the citizens' questions, but must refer the citizens to the local office of the MSR. This, of course, is not an efficient way to handle citizen questions, with the result being that citizens simply don't resolve their questions and don't pay their bills. Rate-setting is another property tax function which arguably should be delegated to the communities so they can exercise some responsibility in their financial affairs. This issue has not been addressed in any legislation. As can be seen by these examples, passage of the revised Law on Local Self-Government has raised a number of important policy and administrative questions which must be faced in the coming months. Resolving these questions will require collaboration among the MSR, the MFE, Barents Group of KPMG Consulting, Inc. and the Urban Institute's Local Government Project.

To begin the process of resolving these questions, we engaged the Ministry of Finance and Economy directly on the issue of devolution of responsibility for property and land tax to the communities. We met with the Head of the Main Department of Revenue Policy to obtain the Ministry's views on devolution of property and land tax administration. We suggested that instead of an "all or nothing" approach, consideration should be given to legislation which would grant the larger communities in Armenia greater authority for tax administration, while giving less authority to the smaller communities which may not have sufficient capacity to properly administer the tax. This proposal was received well and was the basis for further discussions in the property and land tax policy work group meetings. Clearly, much work needs to be done to flesh out the details of how devolution of responsibility for tax administration in the communities will be implemented.

The Ministry of Territorial Affairs (MOTA) wants to take an active role in that work. We signed a work plan with that Ministry in the first six months of the project. That work plan focuses on development of procedures, methodologies and forms for use by the communities in administering property and land taxes. Due to delay in the passage of the Law on Local Self-Government, implementation of that work plan was deferred. Now that the Law on Local Self-Government is in force, MOTA personnel have met with us and expressed their anxious desire to begin the work we previously defined. MOTA personnel have also asked us to ensure that the procedures and methodologies we devise be developed as models which can be implemented across Armenia. We will start this effort in the second half of September.

We have also supported the Ministry of State Revenue in its task to prepare draft property tax legislation. In the first six months of the project, we reviewed a draft law which attempted to merge the property and land tax laws into one law. This approach was rejected by the Government, and a second draft law was proposed. The second draft of the law did not attempt to combine the land and property tax laws, but kept them separate as they are now. In addition, the second draft separated the provisions dealing with buildings from the provisions dealing with transportation vehicles, thus in essence creating two separate property tax laws. The second draft also made changes in some of the tax rates. In May, we made extensive comments to these drafts. The Government apparently rejected these drafts as well. In July, a third set of revisions to the property tax law was prepared. This set of revisions

was very modest in scope, being limited to changing the rate of taxation on motor vehicles and certain buildings and adding a short provision to allow local government to settle taxation with the approval of the MSR, if certain conditions are met. It appears that for calendar year 2002, the MSR will not attempt to introduce major property and land tax reform. The Ministry has decided to wait until next year to prepare wide-ranging amendments to the property tax law. This will allow the tax policy review work to be completed before draft legislation is prepared, which is the proper sequencing of events. Based on our work with the tax policy review, we expect to be heavily involved in the preparation of the new legislation next year.

A formal work plan for the provision of technical assistance to the State Committee of the Real Property Cadastre (SCRPC), consistent with the deliverables and timetable noted in the contract, was signed by Manuk Vardanian, Chairman of the Committee, USAID and the Project on 31 May 2002. The work plan covered the following main areas –

- to conduct a situation assessment of the functions of the SCRPC with respect to identification of taxable properties and valuation;
- to assist in the evaluation of the impact of the 3,000,000 dram exemption from taxation;
- to review the valuation models developed by the SCRPC and provide assistance in improving them;
- to introduce representatives of the SCRPC to alternative methods of valuation by taking them to the United Nations Economic Commission for Europe Working Party on Land Administration (ECE WPLA) Workshop in Moscow;
- to design and implement pilot projects to test the new valuation models;
- to draft a “Valuation Manual” for use by the SCRPC and others in valuing properties for tax and other purposes.

Work began with the SCRPC almost immediately. In June, a workshop was held with representatives of the SCRPC, the Ministry of State Revenue, the Community Finance Officers Association and the Union of Communities. Various alternatives for valuation were discussed and the SCRPC received input from the organizations represented at the workshop. Later in June, SCRPC representatives and the resident real estate tax advisor participated in the ECE WPLA Workshop in Moscow. In August, we reviewed and commented on valuation models proposed by the SCRPC. In general, we concluded that the models were deficient and should be corrected to bring them to international standards. Work under the SCRPC work plan is expected to continue through the end of this year.

In addition, at the ECE WPLA Conference in Moscow, SCRPC personnel examined a model automated mass valuation system developed by the Russian State Land Cadastre organization. The SCRPC sees that system as a possible model for its own efforts here. The SCRPC has prepared a proposed scope of work to implement automated mass valuation in Armenia, and has requested our assistance in implementing that scope of work. The work described in that document goes far beyond the work in our existing work plan and would require a significant level of effort in order to implement. We will work with the SCRPC to put the scope of work into proper format for submission to USAID for funding. If that scope of work could be funded, even in part, it would help the SCRPC make progress toward mass valuation and could put into place the basic framework under which market valuation could be gradually introduced. The SCRPC wants to develop this system because of the experience its personnel received on the ECE WPLA study tour to Moscow.

Obstacles to Implementation

The greatest obstacle to implementation of needed reforms is institutional resistance to change. While there now seems to be a greater commitment to devolution of authority to the communities, we still hear statements which cast doubt on the Government's willingness to proceed with meaningful decentralization. We are continuing to educate in this regard. Likewise, the SCRPC still clings to its belief in cadastral valuation and in programs of massive data collection in order to perform cadastral valuation. Again, we continue to stress the need for less expensive methods of valuation and for simplified valuation models. Overcoming these old ways of thinking will continue to take time and effort.

Conclusion

As compared with the previous reporting period, important progress has been made with respect to land and property taxation reform. Most importantly, the project has brought the various ministries dealing with land and property tax together so they may discuss the issues and work together to effect needed reforms. Three such forums were established for these discussions – (1) the day-long workshop held in June, (2) the two-day seminar in Tsakhkadzor in July and (3) the on-going policy discussions held in the Property and Land Tax Policy Review Working Group.

Beyond the formal dialogs, tangible results can be shown. The Government has apparently decided to forgo piecemeal legislative reform of land and property tax and instead enact comprehensive reform legislation next year, following conclusion of the tax policy reviews. A commitment to getting the policy right before preparing legislation is certainly positive. The State Committee of Real Property Cadastre is moving, albeit slowly, toward market valuation. Its proposed cadastral valuation is approximately 75% of market value, not unlike the "assessed values" which were used by some jurisdictions in the United States to tax at less than full market value. Communities and groups representing communities continue to press for more authority in fiscal affairs. With the passage of the Law on Local Self-Government, the Ministry of Territorial Affairs is now energized and ready to implement its existing work plan. Taken together, these positive steps show the synergy that has been generated across ministries to implement the reforms outlined, however roughly, in the Law on Local Self-Government.

Additional Activities

The following activities were not considered in the proposal submitted by Barents Group of KPMG Consulting, nor were they included within the contract formally signed on 19 September 2001. As these activities were in addition to the deliverables agreed under the contract and outwith the initial work plans agreed between USAID, Counterparts and Barents Group of KPMG Consulting it should be made clear that resources have necessarily been diverted from our agreed deliverables to these tasks. This may lead to a delay in meeting deadlines. These activities were included within a request to USAID for contract modification submitted on 30 June 2002. We await the results of this modification request.

Legal Advisor to provide oversight to Armenian working group on issues related to Land Code implementation.

The Armenian National Assembly passed a progressive Land Code in June 2001. That action necessitated the amendment of a number of normative-legal acts, including the Forest Code, Water Code, Law on Urban Development, as well as action to bring the Land Code and the

Civil Code into conformity with each other. The State Committee of the Real Property Cadastre (SCRPC) formed a working group of five independent experts representing a variety of relevant fields of expertise to examine the various laws and decisions, draft appropriate amendments thereto and ensure their adoption. Sarkis Tovmasyan, Deputy to the Chairman of the SCRPC coordinated the work on behalf of the Committee and the group was subject to the oversight of the Project's Land and Property Tax Advisor.

The required drafts were completed over the period from February through July 2002 and our advisor reviewed all the documents and discussed the content of some of them with the authors. The documents appeared to be consistent with Armenian legal style and Sarkis Tovmasyan has approved the content. One of the documents, the Decree on Transferring the Ownership of State-Owned Land to the Communities, has apparently already been adopted.

The following drafts were delivered by the Working Group:

- The RoA Government Decree "On amending the 12 April 2001 RoA Government Decree # 286 and approving a new version of the procedure established by the decree".
- The "Procedure for the alienation and the allocation for use of State-owned land parcels"
- 7 model forms
- Land parcel donation Contract
- State- and community-owned land parcels exchange contract
- Land parcel sale and purchase contract
- Contract for leasing out the land parcels for agricultural activities
- Land parcel lease contract
- Amendments to the following sections of the Civil Code: 198, 201, 204, 205, 206, 218, 221, 288, 564, 1246.
- Amendments to Decision 656 Regarding Land Balances
- Modifications to the Forest Code
- Modifications to the Urban Development Code
- Modifications to the RA Law on Specially-Protected Areas
- Regulations on Control of Land Use

Based on the foregoing, we can conclude that the work given to the SCRPC has been completed satisfactorily.

Assist the MSR, MFE and MOJ in Combating White Collar Crime.

On the initiative of the Ministry of Justice, represented by Vahe Yacoubian, legal advisor, USAID agreed to assist in the planning and execution of a specific project to examine the problem of large scale tax evasion. The Project took on the active role to conduct a thorough analysis of the current situation and develop solutions, both legislative and procedural, to combat this evasion.

We commenced this work at the beginning of February following a meeting with the Minister of State Revenues and began researching the status of tax evasion in Armenia. The research focused on two main issues. The first issue considered whether the current tax evasion laws were sufficient to prosecute all forms of tax evasion. The second issue looked at whether the procedures in place were adequate to uncover acts of tax evasion and bring the cases to court.

In order to obtain information on these two issues our attorneys met with:

- judges (both from the general court which hears tax evasion cases and from the economic court which hears other tax cases);
- representatives from the MOJ;
- representatives from the MSR, including representatives from its Audit Division and Tax Investigation Unit;
- representatives from the Prosecutor's Office;
- other donor organisations; and
- tax attorneys from the private and public sector.

Based on the data obtained we drafted a report entitled Analysis of Criminal Tax Legislation and Procedures in the Republic of Armenia in May 2002. In general, our findings indicated that existing tax evasion legislation (article 162⁴ of the Criminal Code) is ambiguous, both in terms of what constitutes "ill-intentioned" tax evasion and on how the threshold provided in the article is to be computed. These ambiguities result in the inconsistent interpretation of this article. In addition to these legislative issues there are also differences of opinion on procedures that are to be applied, beginning at the audit stage and continuing through to the trial stage. We recommended that new legislation be drafted (preferably as part of a comprehensive economic crime package) and that changes be made to the current procedures governing tax evasion cases. The report was distributed to all interested parties.

For Stage two of this task we sub-contracted the drafting of new legislation to John Libby, a US based lawyer working for Manatt, Phelps, Philips who are based in Los Angeles but have strong ties in the RA through Vahe Yacoubian, counsel to the Ministry of Justice. The draft legislation, based on our report, was received at the end of August and has been circulated for consideration and comment to the Minister of Justice and other ministries.

A draft Criminal Code passed its first reading in Parliament. The draft Code contains two tax evasion articles. One article applies to individuals who commit tax evasion while working at organizations or while working as entrepreneurs, while the second applies to all other individuals. The draft Code also contains provisions addressing money laundering and other forms of economic crime. Unfortunately these provisions do not satisfy many of the concerns raised in our review but, through Yacoubian, we have made MoJ aware of these deficiencies.

This task is ongoing.

Assist the MTED to facilitate WTO Accession

At the request of USAID a World Trade Organisation (WTO) advisory group was formed by the Project within the Ministry of Trade and Economic Development (MTED). The group consisted of local Armenian consultants having expertise in various areas central to the WTO accession process: Customs and taxation administration; intellectual property rights; sanitary/phytosanitary measures; technical barriers to trade; trade investment measures; and agriculture taxation issues. The group worked under the general direction and guidance of our resident Customs advisor in Armenia.

Starting in February 2002 and over the following six months, the group provided advice and support to the MTED in the preparation of WTO submission documents and responses to the comments of WTO member countries with respect to Armenia's application to join the WTO.

The group began its work by reviewing and updating the WTO country status report for Armenia, and preparing responses to detailed comments and proposals received from USTR. Upon the completion of these deliverables, the WTO Secretariat and the member delegations of the Working Group agreed to hold an informal Working Party meeting in Geneva to consider the progress of Armenia's application for accession to the WTO.

At the WTO informal Working Party meeting held in Geneva on July 22, agreement was reached that a final, formal Working Party meeting would be convened on September 20, at which time Armenia's application for accession would be referred forward to the next WTO general session, likely to be held in mid-October, with a recommendation for approval. Amendments to the WTO Working Party report on Armenia's accession to reflect the decisions of the meeting of July 22 were completed and forwarded to the WTO Secretariat in late August. The package of legislative amendments to support WTO accession were approved by Cabinet in August and forwarded to the National Assembly for consideration in September. On August 31, however, a communication was received by the Ministry of Trade and Economic Development from USTR proposing that the final Working Party meeting be delayed pending their presentation to the Government of Armenia of additional comments and outstanding issues. The Ministry of Trade and Economic Development is awaiting clarification from USTR to determine a timeframe for the presentation by USTR of its comments, and a date upon which all parties can agree to hold the final Working Party meeting.

As part of the process we proposed wording to amend sections 87 and 88 of the Customs Code and presented those changes to senior officials of the Customs Committee and the Ministry of Trade and Economic Development to resolve an impasse between the two Ministries. The proposed wording was agreed to by both as meeting WTO requirements while still providing to Customs the capacity to administer valuation determination provisions without loss of control or significant reductions in revenue. The required amendments to the Customs Code to give effect to the proposed wording were distributed to other delegations for review to confirm their agreement that the amendments were compatible with WTO requirements, and no objections were received. The amendments to the Customs Code are included in the WTO legislative amendment package that has been forwarded to the National Assembly.

Following conclusion of the work of the WTO advisory group in August 2002, our resident Customs Advisor is continuing to provide advice and support on an ongoing basis to officials of the Ministry of Trade and Economic Development on WTO accession issues.

This activity continues.

Completion of the Wide Area Network for the Tax Administration

In June 2002, at the request of USAID, we completed an assessment of the work done to date by a local firm InfoService, a subcontractor to SETA, who had been awarded the contract by IRM. The original agreements between SETA and InfoService covered the implementation of eight tax offices in Yerevan, ten tax offices in the Marz Centres and nine customs points (which are no longer required). As of the completion of the WAN assessment, eight Yerevan tax offices were implemented and the connections to three Marz Centres—Armavir, Eghegnadzor, and Giumry—were tested. The connections to the Yerevan offices were performing well with the exception of the Shaumian office. The tested connections to the

Marz Centres generally worked well, although the Armavir office had similar problems to the Shaumian office. The remaining seven Marz Centres had not been connected. There are also nine new tax offices that need to be connected to the WAN. The assessment report detailed the problems and offered options and recommendations for completion of the WAN. During the assessment we were also able to provide solutions to most of the technical problems.

It was clear that SETA's management of the contract and their subcontractor InfoService had been inadequate. Indeed, on many occasions over the life of the contract Project personnel were commandeered into providing technical and practical assistance. Funding for the contract by SETA has now expired and USAID have requested the Project take over this work and follow through to completion. This work is the subject of a contract modification currently under consideration by USAID.

Nine new tax offices need to be added to the WAN for the proper and efficient operation of the Armenian Tax Information System. This will also necessitate additional equipment as well as the practical installation and maintenance. On 15 July 2002 the Project received authority from the Contracting Officer to make payment for the MSR WAN maintenance service in Yerevan to InfoService in an amount not to exceed \$3000.00. As at the end of August we have made 2 payments in the total amount of \$1300 for the months of June and July 2002.

Due to SETA's disappearance from the scene and recognising the importance of the WAN in respect of tax administration reform the Project took the initiative and pushed InfoService to complete the connections to the outstanding seven Marz offices. This work was completed by the end of August and can be regarded as a tremendous achievement considering the unnecessary delays that had occurred.

To facilitate full completion of the WAN with the additional tax offices as early as practical, we have agreed a work plan with InfoService.

This activity continues.

Budget Status as at 31 March 2002

The estimated cost for the performance of the work as noted within the contract is \$12,794,416 exclusive of the fixed fee of an additional \$914,317 with a total therefore of \$13,708,733. The line items are budgeted as follows:

CLIN 0001	Technical Assistance to the MFE	\$4,840,443
CLIN 0002	Technical Assistance to the MSR – Tax Administration	\$3,827,545
CLIN 0003	Technical Assistance to the MSR – Customs	\$4,126,428
CLIN 0004	Fixed Fee	\$914,317
		\$13,708,733

As per 31 August 2002 the following amounts have been invoiced to USAID:

CLIN 0001	Technical Assistance to the MFE	\$1,330,190	27%
CLIN 0002	Technical Assistance to the MSR – Tax Administration	\$1,329,091	35%
CLIN 0003	Technical Assistance to the MSR – Customs	\$1,050,039	25%
CLIN 0004	Fixed Fee	\$265,046	29%
		\$3,974,366	29%

It should be noted that we expect to issue Request for Proposals (RFP) during the next quarter to reflect equipment purchases for the Ministry of State Revenues and the State Customs Committee for a total value of approximately \$1.6 million which is as budgeted within the contract. The only difference is that the sum had been budgeted over the life of the contract rather than being specific to the first year.

Further, a contract modification, currently under consideration by USAID, has been requested to add a relatively small amount of further funding to cover some of the additional activities taken on by the Project.

Appendix 1

Technical Memoranda

Date	Subject
Monthly	Economic Update
Monthly	Budget Bulletin
20 April 2002	Functional Requirements Specification for the Production Goods Module
1 May 2002	Analysis of Criminal Tax Legislation and Procedures in RA
15 May 2002	Review of Second Draft of Property Tax laws
2 June 2002	Technical Proposal for Budget Information System Enhancements
13 June 2002	Options and Recommendations for Completing the WAN for the MSR
14 June 2002	Award of Sub-contract to AVAG Solutions Ltd – MTEF
19 June 2002	Draft Report on Intergovernmental Finance Review
24 June 2002	Framework for Tax Policy Review
4 July 2002	Report on Study Tour – WPLA Seminar in Moscow, Russia.
11 July 2002	Review of Draft Law on the Taxation of Passenger Cars
12 August 2002	Award of Sub-contract to CFOA – IGF Database
21 August 2002	2003-2005 Medium Term Expenditure Framework
27 August 2002	Review of Valuation Procedures for the Armenian Property Tax
30 August 2002	Paper on Inflation Growth and Money Demand
March through August 2002	Technical Memoranda on the Process for the Poverty Reduction Strategy Paper